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CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON LOCAL GOVERNMENT FINANCE

LOCAL GOVERNMENT FINANCE STUDIES

Memorandum by the Chancellor of the Exchequer

Local Government Finance

1. I agree that our system of local government finance cannot be left as it is, and that radical change is needed. But it is important to distinguish between two distinct issues: first, the structure of local government finance and, second, the precise nature of the tax which local authorities are empowered to levy.

The Structure

2. I believe it is well worth pursuing further the proposals which Kenneth Baker and William Waldegrave have made to enhance local accountability by making radical changes both in the system of Exchequer grants to local authorities and in the way revenue is raised from non-domestic properties. This approach has a clear and coherent rationale, based on greater local accountability. I am also attracted by their subsidiary proposals for annual elections, for the greater use of fees and charges, and for overhauling local authorities' budgeting framework.

3. There are clear attractions in stopping local authorities from financing profligate expenditure by increasing the burdens on businesses - who have no say in the level of expenditure or rates. Nationalising non-domestic rates is one clear solution to this problem. We need to look carefully at the effects this would have on individual businesses and on income to different local authorities. Moving to a single national rate would have the effect of raising rates for those businesses who have deliberately chosen to locate in low-rate areas. We must therefore look at the pattern of gainers and losers and at the various options outlined in Annex A of the Specification Report. The report already makes clear that some special arrangements would have to be made for London.

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4. Fixed needs grants and per capita grants also have clear attractions. They would help to put the full burden of financing marginal expenditure on to the local community. But we shall need to consider whether a new system on these lines would, on its own, provide adequate pressures to hold the really high spenders in check. We cannot take a firm view until we have proper estimates of the likely effects of the proposals on local spending: we might, for example, need to retain powers to limit the expenditure, (or, failing that, the revenue) of the very high spenders, or to withdraw grant from them.

Education

5. The Secretary of State for Education and Science has suggested in E(LF)(85)2 that we should look also at changes in the way education is financed. I agree. Indeed, I think we should go further than he proposes and consider the implications of the Government taking over complete responsibility for the financing and some aspects of the management of education. The financing could be done either by retaining the proceeds of non-domestic rates as a national tax or by hypothecating the bulk of the present RSG specifically to education expenditure. Either way that would give us the opportunity of reducing local authorities' reliance on central Government funding and of producing a closer link between local expenditure and local revenue. It would give us a better chance of securing the delivery both of the major educational reforms set out in "Better Schools" (Cmnd 9469) and of a more coherent system of salaries and conditions of service for teachers.

Local taxation

6. It is only when we come to the question of what local tax we should have that I have to depart altogether from the proposals in the Specification Report. The report recognises that a flat-rate poll tax would be politically unsustainable; even with a rebate scheme the package would have "an unacceptable impact" on certain types of household. The biggest gainers would be better off households in high rateable value properties; the losers would be poorer households, particularly larger ones. Tables 3(a) to 3(e) give a horrifying picture of the impact. A pensioner couple in Inner London could find themselves paying 22 per cent of their net income in poll tax, whereas a better off couple in the suburbs pay only 1 per cent.

7. We should be forced to give so many exemptions and concessions (inevitably to the benefit of high spending authorities in Inner London) that the flat-rate poll tax would rapidly become a surrogate income tax. That is what a "graduated residents' charge" is. The Introductory Report, for very good reasons, rejects local income taxes.

8. What we need to do is to devise a system of local property taxation to replace the existing rating system. Taxes on property are cheap to collect and difficult to avoid. They have a clear local base. They bear some rough relationship to ability to pay - not perfect but inevitably better than that for a poll tax. They allow us to keep a broad tax-base and reduce our reliance on taxes on income; nearly every industrialised country has a tax on domestic property.

9. It is true that rates, however reformed, are unlikely to be a very popular form of taxation. But as the Specification Report itself points out, "Better accountability requires a highly perceptible, and therefore unpopular, tax".

10. Our proposals on housing benefit are a very important reform, not least in this context. They substantially change the nature of rates by extending their impact much more widely. This will go a long way towards improving accountability by the maximum

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amount which is feasible - given that a non-rebated poll tax is inconceivable. After these changes, rates will in practice be borne by the great majority of local electors. There may be only 18 million householders out of 35 million voters. But most of the remainder are in the report's own words, "spouses or co-habitees". Some 86 per cent of households are either single adults or married couples with dependent children.

11. There are other reforms we could usefully make. An adjustment could be made based on occupancy - a fixed percentage discount, say, for pensioners living on their own; or alternatively a fixed percentage surcharge for additional adults.

12. Revaluation is - rightly - seen as a major problem with the existing system. There is scope for reform here too. If we were to move to capital valuation for domestic rates we could have an annual programme of rolling revaluations which would minimise the disruptive changes inherent in the present system. Capital values would be far more comprehensible - and we could if necessary introduce a banding of values so that the redistributive effects were not too severe. Whatever system we adopt we should learn from this year's experiences in Scotland: we should always ensure that revaluations - and other changes - are phased in over a reasonable period. The problems of an old-style revaluation upheaval would, of course, be magnified many times during the period of transition from rates to poll tax. This is not simply a hideous political problem: local authorities would seize the opportunity to bump up their spending and revenue and blame it all on the imposition by the Government of an alien system of taxation.

Public expenditure and the PSBR

13. We also need to be clear about the public expenditure, revenue and PSBR effects; their consequences for manpower in central and local government; and the gainers and losers among local authorities, non-domestic ratepayers and individuals and households. I am also concerned about the relationship of these proposals to the other major restructuring proposals we are considering, particularly in the social security field (including the abolition of SERPS). We need an overall assessment of the macro and micro-economic effects, including the implications for the supply side and for the pattern of marginal rates of tax and benefit. We need in particular to look at the cumulative effects on income distribution.

14. The studies carried out so far give no more than a sketchy indication of all this. I must ask that this aspect of the work is taken forward urgently in close association with my officials.

Conclusion

15. I see much merit in most of the proposals in the Specification Report. We should certainly look further at nationalising non-domestic rates and at fixed needs grants and per capita grants. But the proposal for a poll tax would be completely unworkable and politically catastrophic. A radical reform of the rating system seems a more attractive option.

N.L.

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